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How to Administer Your Irrevocable Trust:

Practical Suggestions, Traps to Avoid, and Dealing with Modern Complex Trusts

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Introduction

The focus of estate planning is often the creation and funding of irrevocable trusts. Transfers to irrevocable trusts can remove assets from the reach of future creditors to provide asset protection benefits and shift the assets and the growth in the value of those assets outside of the transferor's estate. With the potential for future restrictive estate tax law changes, e.g., reducing the exemption amount many taxpayers have or will endeavor to shift assets out of their names and their estates to protective trust structures. For example, in 2012 there was a significant amount of planning undertaken out of concern that in 2013 the exemption amount would decline from $5 million inflation adjusted to a mere $1 million inflation adjusted. Taxpayers rushed to complete planning before year end out of fear of that change becoming a tax reality. But the change never occurred. As a result, many taxpayers who undertook tax-oriented planning in 2012 became disillusioned with the planning and never followed up. In 2020 a similar situation occurred in that many taxpayers rushed to complete tax-oriented planning before the end of 2020 in order to have that planning completed before possible harsh restrictions on estate, gift, and generation skipping-transfer ("GST") tax rules under a Democrat administration. But consummating the planning is only part of the process. The other part, which is far less exciting or noteworthy, is administering the trusts and other planning once created. Practical suggestions for administering estate plans concentrating on irrevocable trusts is the focus of this report. A not so exciting, but an ever so important, topic. Failing to properly administer the irrevocable trust that forms the core of an estate plan could undermine the entire plan, not just the trust. It can result in a loss of asset protection and tax savings. If trusts that are designed as an integral part of an integrated estate plan fail, the overall plan may result in distributions that are not what the settlor intended. The consequences of a failed plan can be catastrophic. Yet, many irrevocable trusts are simply not administered properly; some are largely ignored. It is not uncommon for an estate planner, trust officer, or CPA to learn of an irrevocable trust that a client created years or even decades earlier with no attention whatsoever having been given to the administration of that trust. While many taxpayers understand the need to change the oil in their cars every 5,000 miles, they overlook the need to monitor and tune-up trust operations.

There is no question that trusts which name a professional or corporate trustee tend to be administered with more attention than those naming family members and friends. Some of the points discussed in this article will be helpful to even professionally administered trusts.

Why Trust Administration is so Important

Simply put, if the trustee and others involved with a trust do not respect the independence and integrity of the trust, it will be difficult to convince a court that a creditor or the IRS should be required to respect that trust.

Example: Physician creates an irrevocable trust and transfers assets to that trust with the hopes of insulating

those assets from the reach of malpractice claimants. The trustee fails to issue the annual demand (Crummey) notices each year when gifts are made. Physician fails to segregate trust and personal assets, paying personal expenses out of the trust, etc. The trust is a grantor trust, and no separate grantor trust income tax return was filed. Physician is sued and the claimant argues that the trust assets should be reachable since the integrity of the trust was not respected by the Physician. Whether the trust assets will escape may be a question of fact for a court to decide. It certainly would have been preferable for the Physician to have adhered to as many trust formalities as possible. Even if the trust succeeds in deflecting the challenge, the angst to the Physician will be tremendous, and the costs of defense exponentially more than the cost that would have been involved to have administered the trust properly.

Example: Wealthy Taxpayer gifts a $10 million interest in a real estate LLC to an irrevocable trust to use her gift and GST exemption and grow the value of the assets outside her estate. Several years after the transfer she begins drawing a salary from the LLC that is out of proportion to the value of any services rendered. Her daughter graduated from college and needs financial help, and she is added to the payroll but provides no services. When her son marries, she takes a large distribution to pay for the wedding. After she passes away the IRS audits her estate and argues that the entirety of the LLC value should be included in her estate, as she retained excessive control and enjoyment over the income of the LLC after the transfer. The estate plan failed.

Be Certain the Trust is Funded

A threshold issue in early trust administration is to be certain that the trust is funded, that is, that the intended assets are transferred to the trust. Surprisingly, some taxpayers will go through the work and cost of creating an irrevocable trust, but never follow through on actually transferring the assets to the trust. A not uncommon situation is for a taxpayer to plan to buy life insurance and hire an attorney to draft an irrevocable life insurance trust (“ILIT”). The trust is completed and to save money, the taxpayer advises the attorney that she will coordinate the transfer of the insurance to the ILIT with the insurance agent. While the legal costs of the attorney follow-up were saved, the taxpayer never contacted the life insurance agent and the transfer was not made. Because the existing policy was being transferred to the ILIT, the proceeds will be included in the insured’s estate if she dies within three years of the transfer. While a sale might have avoided that problem, the insured taxpayer opted to handle the matter on her own. Failure to complete the funding of an irrevocable trust does not seem to be rare event. Follow-up details, even one as important as funding, sometimes get overlooked while those involved focus on the terms of the trust and overall plan. A simple and safe way to address this and many other oversights is to schedule a follow-up meeting to review the status of the irrevocable trust with the entire advisory team. There invariably are some issues for many trusts post-signing, and a review by all advisers will likely identify them so that they can be addressed.

Trust Agreement Annotation

When a trust is being completed the focus is generally on the plan, trust terms, who to name as trustees, distribution provisions, etc. However, when a trust is completed, attention must turn to the administration of the trust. That will often require a focus on different provisions of the trust instrument, including administrative provisions that the settlor and trustee gave little attention to during the planning process. It may be helpful to annotate the trust instrument highlighting the provisions relevant to the administration of the trust to serve as a guide to an individual trustee, as well as others named in the trust instrument, e.g., a trust protector. Separate annotations might be created for an individual trustee, trust protector, and others, so that each has a document highlighting the provisions most relevant to their respective roles. It is common for an institutional trustee to create a summary or template of each trust which can be helpful during administration. A similar approach should be useful for non-institutional trustees. The annotation can then be reviewed at each annual trust review meeting to be certain all those involved in the administration of the trust understand their respective roles.

Compliance with Specific Trust Requirements

Many trusts, especially those with specific tax requirements, must be administered in a manner that complies with those requirements. The trustee and other fiduciaries, as well as the advisor team, should understand these nuances, and it should be clearly determined who will be responsible to assure that the trust is operated in conformity with those requirements. Compliance can be evaluated at the annual trust review meeting and corroborating documentation confirming compliance saved for future audits. The following is a general and simplified overview of some of the requirements of various trusts or trust plans that illustrate some of the specific requirements some trusts face.

ACCUMULATION TRUST—this is a trust designed to hold IRA and retirement assets. Following the Secure Act, only Eligible Designated Beneficiaries will still qualify to stretch payments over life expectancy. The trustee has discretion as to distributions which can be valuable, but all funds have to be paid to the trust at the end of the tenth year following the death of the plan holder, which might result in compressing the entire balance in taxable income of the trust in one year. That can create costly tax consequences that should be planned for in advance.

BDIT—Beneficiary Defective Irrevocable Trust is a trust that is characterized as grantor for income tax purposes as to a person other than the settlor. This might be accomplished by giving the designated a Crummey power over assets issued to the trust. The gift to the trust from the settlor should be documented and the issuance of the required demand notice assured.

BDOT—Beneficiary Deemed Owner Trust is a trust that is characterized as a grantor trust as to a person other than the settlor. For example, a person may be given the right to withdraw certain income from a trust, thereby making that income taxable to that person. That might be done to reduce state income taxation. The income over which the power is exercisable, and the proper reporting of that income by the powerholder, should be monitored.

CLT—Charitable Lead Trust requires that a payment be made each year to the charity or charities designated in the instrument. That payment may be structured as an annuity payment or a unitrust payment and should be calculated and paid accordingly.

CONDUIT TRUST—this is a trust designed to hold IRA and retirement assets. Following the Secure Act, only Eligible Designated Beneficiaries will still qualify to stretch payments over life expectancy. As a result, no payments have to be made until the end of the tenth year following the death of the plan holder, at which time all funds have to be paid out to the named beneficiary. That can create a host of financial and tax issues that should be monitored in advance.

CRT—Charitable Remainder Trust is the inverse of the CLT above and requires that the designated "people" beneficiaries receive a payment each year, with the remainder going to charity. That payment may be structured as an annuity payment or a unitrust payment and should be calculated and paid accordingly. If the payment is a unitrust the trustee will have to determine the value of trust assets to make the calculation. Also, the trust investment policy statement ("IPS") should be tailored to reflect the payment.

ESBT—Electing Small Business Trust holds S corporation stock so compliance with the ESBT and S corporation rules should be monitored. The trust will have to pay income tax at the highest rate on S corporation income, and that payment should be made. The appropriate election for ESBT treatment should also be made.

GRANTOR TRUST—the income of a grantor trust is required to be reported on the grantor's income tax return. Whether or not a separate tax identification number should be issued to the trust, and whether or not the trust should file a grantor return, should be addressed. Grantor trusts might include an array of special powers or provisions that non-grantor trusts do not have, such as a power to swap or substitute assets of equivalent value for trust assets, a discretionary right in the trustee to make tax reimbursement payments to the settlor, the power someone may hold to add additional beneficiaries, etc. The status of these powers, whether they should be or were exercised, etc. should be monitored. See discussion below.

GRAT—Grantor-Retained Annuity Trust is a trust that requires the payment of a periodic annuity which can be a fixed amount or an increasing amount annually. The payments are generally due with a 105-day grace period. Success of a GRAT may rest on making the required payments on a timely basis. Someone should monitor the payments and save proof that they were made on a timely basis. GRATs often include a valuation adjustment mechanism. If there is an audit of the value of the assets transferred to the GRAT, someone needs to make certain that if that mechanism was triggered the annuity payments are addressed accordingly.

ILIT—Irrevocable Life Insurance Trust generally holds a small dollar bank account and one or more insurance policies. In the typical ILIT, gifts are made annually and annual demand or Crummey power notices issued, then the premium paid. If this is the case for the particular ILIT then the trustee should be certain that the notices are issued as required under the terms of the trust and premiums paid. In some cases, annual gifts made by the settlor to other trusts or family members may require a determination of the annual gift exclusion available for gifts to the trust in each year. If the Crummey notices "hang" then some records of those amounts should be retained. A common oversight for ILITs is the failure of an individual trustee to review the life insurance in the trust periodically. Often, the policy is not considered after the initial purchase.

NOTE SALE—These assets may be sold to a trust. Typically, but not always, the trust is a grantor trust. When there is a sale, someone should assure that the required note payments are made as required pursuant to the promissory note and that the assets sold are properly reflected on financial and accounting records as provided for in the sale.

QSST—Qualified Subchapter S Trust holds S corporation stock so compliance with the QSST and S corporation rules should be monitored. The trust will have to distribute income to the beneficiary, who will have to pay income tax on those amounts, and those payments should be monitored. The appropriate election for QSST treatment should also be made.

QTIP—Qualified Terminable Interest Property Trust is a trust that qualifies for the marital deduction, and it should be confirmed that the terms of the trust and the QTIP requirements are adhered to, e.g., payment of income at least annually to the spouse, that the spouse has the right to demand that assets of the trust be invested in a manner to produce income, etc. The IPS for the trust should be tailored to reflect these QTIP requirements.

SPLIT-DOLLAR LIFE INSURANCE—Split-dollar is a means of financing the purchase of life insurance. Family split-dollar arrangements may be made with an ILIT as a party. If, for example, a loan split-dollar arrangement is used, a statement required by the Treasury Regulations has to be attached to the tax returns for the parties in order for the arrangement to qualify as loan split-dollar. Someone should confirm that the appropriate statements are filed.

VALUATION ADJUSTMENT MECHANISM—This is a technique to endeavor to adjust the value of an asset gifted or sold to a trust. There are many variations of these techniques, but it is important that whatever technique is used that the impact of the technique is reported consistent with the technique used on all income tax returns, financial reports, trust statements, etc.

Example: Taxpayer gifted $10 million of LLC interests to an irrevocable trust. If the IRS adjusts that value on audit, either the interests in excess of that value will not have been transferred to the trust or will pour into a non-taxable receptacle (which might be an incomplete gift trust, a GRAT or other mechanism). The forms K-1 for the LLC taxed as a partnership should reflect the uncertainty as to which member owns what percentage interest in the LLC pending confirmation by the IRS of the gift tax value as finally determined (or the passing of the time period during which an audit can be conducted). Similarly, the trust records should similarly indicate that the ownership interests are not fixed percentages and may be determined by a future gift tax audit. Demonstrating respect of the formalities and realities of the adjustment mechanism may be helpful to deflecting a challenge by the IRS or another third party. If years in the future there is an adjustment as a result of an IRS audit, that adjustment should be reflected in the ownership percentages, and make-up provisions may be triggered to allocate the prior distributions and income as between the parties to reflect the finally determined values.

Tax Compliance

When a new trust is formed or a new trustee named, or the trust terminated, Form 56 should be filed with the IRS alerting the IRS to the new trustee or other matter. This is important to assure that the IRS has the correct current trustee name and address so that IRS notices will be received.

Income tax returns may be required for the trust, and income tax returns of the settlor or others may be affected by the planning done. The tax preparer should be authorized and directed to consult with the attorney who prepared the trust so that there is agreement as to the tax status of the trust for reporting purposes. As discussed above, if a valuation adjustment mechanism is used it should be reflected in a statement attached to the return clarifying any percentages reported. If there is a split-dollar loan, a statement may be required to be appended to the return. It is important that the tax preparer be made aware of the overall plan, what was done with respect to the particular trust for which they are preparing a return, etc. In many instances, the person responsible for preparing a tax return reporting the planning and creation or funding of a trust may not have actively participated in the creation and implementation of the plan. Assuring the preparer has that knowledge is critical to the proper preparation of the returns involved.

Gift tax return reporting may also be required. Even for transactions that are not intended to be gifts, e.g., a note sale of a business interest to an irrevocable trust pegged at the fair value of that interest, might warrant reporting to assure that the statute of limitations tolls for audits. That requires adequate disclosure of the transaction on the return. Again, it is essential that the preparer have an understanding of the details of the transaction and all relevant documents to do this. Gift tax requirements can arise in future years as well. In the more obvious way, if additional gifts or transfers are made to a trust in a later year a new gift tax return has to be filed. But

there may also be less obvious reasons triggering a filing requirement. The settlor might pay trust expenses (trustee fees, tax preparation fees) directly for the trust, and those payments might constitute indirect gifts to the trust. So, all involved with the trust should be alerted to these types of issues.

Consistent tax reporting to transfer and trust documents is important and should be facilitated by the trustee and the entire advisor team.

Reporting To Beneficiaries

Many trusts require that the trustee communicate certain information about the trust to the beneficiaries. Other trusts, called "silent trusts," may expressly prohibit communication to beneficiaries of the trust, for example, while the settlor or the settlor's spouse is alive. Apart from what the trust provides for, state law may have mandates for reporting to beneficiaries that may be overridden by express terms of the trust. For example, state law might require reports be given to beneficiaries unless expressly prohibited in the trust document. Another aspect of this is that many trustees strongly prefer to report regularly to beneficiaries. Some state laws limit the rights of beneficiaries to assert claims against trustees if beneficiaries receive certain types of reports. Some institutional trustees will not accept a trust appointment that restricts their ability to report (absent perhaps extenuating circumstances such a mental health issue affecting the beneficiary) because of the impact on their liability exposure. Apart from the legalities, there can be important personal impact on the beneficiaries. In some instances, for example, a beneficiary struggling with an addiction issue could be severely harmed by learning about new trust benefits. A more common situation is that a planned phased introduction to the beneficiaries of the existence of a trust that benefits them, then perhaps some of the benefits under the trust, and over time increasing information as to the financial status of the trust, may be the ideal way to acclimate and educate a beneficiary as to the trust. All of these factors should be evaluated and addressed not only when the trust is created but as circumstances evolve. The decision, as illustrated above, should not only be evaluated at inception based on the document and applicable law, but should be revisited based on changes in trust assets, needs and maturity of beneficiaries, and other relevant factors. As beneficiaries grow it may even be reasonable to include them to some degree in an annual trust meeting. The key point is that best addressing reporting to beneficiaries requires knowledge of the trust terms, trust assets, and personal characteristics of the beneficiaries over time. Too often, trust administration is reduced to the mechanical steps of issuing annual demand or Crummey powers and filing a tax return. Rarely will that approach suffice.

Review Powers

Trusts can include a variety of powers, other rights, and planning mechanisms. These can easily be overlooked, and the recommendations above of creating an annotated document highlighting key trust provisions, and annual review meetings at which the powers can be discussed is advisable. Some of the powers or rights to address include those below, but there are a variety of others that might exist.

It is common to include various powers of appointment in a trust document. Various persons can be given a specified power. This might include trustees or beneficiaries, but powers can also be held by people who are not beneficiaries (collateral powers). There are several types of powers. For example, for tax purposes a power that is a limited or special power does not cause estate inclusion to the powerholder. A general power of appointment will cause estate inclusion. Some powers might be crafted as special powers, but there may be a mechanism for that power to be transformed into a general power.

Example: A family trust is created that provides benefits to the settlor's spouse and descendants. The spouse is given a limited power of appointment over the trust to appoint trust assets amongst the descendants of the settlor and the spouse. That is a "narrow" limited power as the class of beneficiaries that can be appointed to is limited. The spouse can exercise that power, pursuant to the terms of the trust, and appoint the trust assets to descendants, in trust or not, as the power permits. This is a common power used to provide flexibility to address changing circumstances of the heirs or changing tax laws. The trust might permit a broad limited power which could permit the spouse (or another person) to appoint trust assets to anyone other than the spouse, the spouse's creditors, the spouse's estate, or creditors of the spouse's estate. That type of power might even conceivably permit an appointment back to the settlor, but caution should be exercised.

Other trusts might include powers that can provide a mechanism to benefit the settlor of the trust in the future. A self-settled trust, called a Domestic Asset Protection Trust ("DAPT") is a trust that includes the settlor as a beneficiary. That type of trust is permitted under the laws of 19 jurisdictions. If the settlor resides in a state

that does not permit self-settled trusts, that type of trust must be created in one of the 19 states permitting it. Some believe that the home state that does not permit these types of trusts may pierce the trust and apply local law. An approach some believe might reduce that risk is to create what is referred to as a "Hybrid-DAPT." This is a trust that does not initially include the settlor as a beneficiary, but to which the settlor can be added in the future as a beneficiary by a person holding the power to do so. Another approach involves including in the trust a Special Power of Appointment Trust ("SPAT") give a person, in a non-fiduciary capacity, the power to direct that the trustee makes a payment to the settlor (or perhaps the descendants of the settlor's grandparents). That provides the settlor with a mechanism to benefit from the trust without becoming a beneficiary.

If these powers are included in a trust they must be monitored. Should they be exercised? If so, what precautions might be considered before doing so? It may be important to confirm that the powers have not been exercised as that may have import to who the trustee gives reports to. Thus, it might be prudent to confirm at an annual trust meeting that people holding these powers have not exercised them.

Some trusts grant to a person the power to add a beneficiary, e.g., a charity. These types of provisions can come in a variety of structures. Some trusts grant this power to the trustee, and that might raise concerns over whether the trustee can add another beneficiary without violating the trustee's fiduciary duties to the other beneficiaries. Other trusts may grant this power to a person in a non-fiduciary capacity so that there is no responsibility to other beneficiaries. This type of power may be constrained by requiring the approval of another person, e.g., the settlor's attorney, before a new beneficiary can be exercised. All of these rights, in whatever form, need to be reviewed periodically to determine if they should be exercised, and if so, how.

A swap power, briefly discussed above, is a common technique in trusts that are characterized as grantor trusts for income tax purposes. This is also called a power to substitute, and it typically grants the settlor (but it could be another person) the right to substitute cash (or another asset equal to the value of an asset in the trust) for that trust asset. The common application of this technique is to pull highly appreciated trust assets into the settlor's estate so that on the settlor's death they may benefit from a step-up in tax basis (the basis for determining gain or loss is adjusted to the fair market value at death).

To determine whether to exercise a swap power for this purpose, the settlor's health must be monitored. The appreciation in trust assets must be monitored. That could be particularly complicated and involved if the assets are non-marketable closely held business or real estate interests. This level of coordination and monitoring does not happen with sufficient frequency for many trusts. The suggestions above for an annual review meeting may be insufficient for an infirm client.

Another common power given to the trustee of some irrevocable grantor trusts is the right to reimburse, in the trustee's discretion, the tax the settlor paid on trust income. This "tax reimbursement power" should be exercised with discretion as the payment to the settlor negates some of the benefits of the trust shifting assets outside the settlor's estate. The payment adds assets back to the settlor's estate. Thus, if the settlor desires or needs such a payment, it might be prudent to have financial forecasts completed to demonstrate whether or not the reimbursement is really necessary. Other options might also warrant further analysis. If, for example, the settlor is motivated by cash-flow issues, might the trust be able to loan the settlor funds instead of making a payment that adds to the settlor's estate? Again, a more proactive level of review and administration may have considerable benefits.

Flexible Trusts Create a Greater Need for Periodic Review

Modern trust drafting has infused many trusts with an array of mechanisms that can facilitate adjusting the trust plan as circumstances evolve. Trust protectors have grown common and are often given an array of powers to modify a trust. Decanting has become more common as more than a score of states permit an existing trust to merge into a new trust that may have different administrative provisions. Non-judicial modifications may permit even broader modifications to irrevocable trusts. The existence of various powers may also facilitate effectuating change in an otherwise irrevocable trust. Traditionally, most people viewed an "irrevocable trust" as one that cannot be changed. But the law has evolved so that is no longer necessarily the case. What does all of this have to do with trust administration? Everything. In the past before these mechanisms became more common, there may have been more limited options to address the administration of an irrevocable trust. For many trusts today, however, irrevocability may not be as restrictive as it had been viewed. Thus, when administering a trust more questions can be asked about options. If a trust does not permit certain administrative

steps that might be desirable, a decanting may change that. If a trust is incurring state income taxation in a high-tax state, it may be possible through a change in trustees, change in situs, or other actions of a trust protector to change that result by shifting trust income to a no-tax state. Thus, the more flexible the trust options are, the more complex and robust trust administration can be.

Conclusion

Trust administration is a vital step to increasing the likelihood of any estate, asset protection, or trust plan accomplishing its intended goals. A foundation of trust administration may include creating an annotation or summary of the trust and holding periodic meetings with all relevant parties. Trust administration includes basic and obvious steps of being certain that the assets intended to be transferred to the trust are so transferred. But it also includes less obvious steps of reviewing the purpose and assumptions of the trust as time passes to assure that the initial or new current goals are being met. If not, the trust instrument should be reviewed and decisions made as to what steps might be prudent to adjust the plan in a manner that may meet goals.

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